RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

Since 1958 •

Post Office Box 1759, La Jolla, California 92038

26 Letters Per Year • $250 annually

June 3, 1998 **LETTER 1253**

OVERVIEW: Commodity indices have caved in, gold has plunged below 300, silver has collapsed, the yen keeps falling along with the ruble, the Nasdaq has been dropping precipitously, and US tech stocks have been whacked along with the Transports. Consequently, I have to wonder whether Asian (or is it world) deflation isn't beginning to hit the US. Again, we might remember that when one-third of the world's GDP (which is what Asia represents) is in trouble, some of that trouble is going to rub off on the other two-thirds of the world's economies (meaning Europe and the US). A warning from *13D Research, Inc.*, the outfit which has had absolutely the best record on Asia [(208)726-1565], *"The real problem that still lies ahead for Asia is the collapse in property prices that will hit a very weakened and fragile banking system -- and rising unemployment with no social safety nets."*

What Are They Thinking? S&P earnings increased a meager 3.7% year-over-year in the first quarter of '98. But analysts remain bullish. *First Call* is the well-known Boston-based earnings tracker. They say analysts have trimmed their estimates for the current quarter, but they state that analysts predict a 5.7% rise in S&P operating earnings for this second quarter. The current consensus is for a 12.7% S&P profit increase for the third quarter and a big 17.3% profit spurt in the fourth quarter. Will the collapsing Asian situation, the strong dollar and surging negative US trade balance upset the analysts' calculations? We'll see.

THE MARKET: The bull still resides in the "Investment Position" box, even though the market has been ragged. Remember, money is continuing to pour into mutual funds at the rate of at least $4-5 billion a week. With that massive amount of money coming in, the only surprise is that the market hasn't acted better. Of course the answer to that puzzle is that there's been sufficient selling over recent months to contain the market within a broad trading range.

In recent Letters I've been pointing to the fact that the Transportation Average has been diverging from, or lagging, the Industrial Average. What does this really mean? The Industrial Average reflects **the manufacturing capabilities** of the nation while the Transportation Average reflects the **sales and the shipping** of that merchandise (of course, the Transportation Average also reflects travel, both for business and pleasure). If the goods are manufactured but not shipped by the nation's transportation facilities, there's a problem. By the same token, if the sales are made, but manufacturers (i.e., the Dow) are not profitably supplying the goods, there's a problem.

The stock market likes harmony, which in stock market terms means both Averages, Industrials and Transports, must move in the **same direction.** When the Averages diverge, move in opposite directions, such action creates dis-harmony or a kind of technical vacuum. The stock market (like nature) abhors a vacuum, and it moves to fill it.

As you can see on the page 1 chart, the Dow has been in a broad rising trend, although, since early April, it's been "consolidating." On April 16 the Transports recorded a bull market high of **3686.02,** and since that date the Transports have been in a declining trend (this despite falling oil prices).

May 22 DJIA 9114.44; PTI 5335; A-D Ratio +10.79
May 29 DJIA 8899.95; PTI 5331; A-D Ratio +10.41
Dow Yield: 1.60%; Dow Price/Earnings: 22.9
Dow 144-day MA: 8530; Dow 34-day MA: 9021
Dow Times Book Value: 6.29; PTI 89-day MA: 5294
Percentage of Undervalued Blue-chips: 3%
Gold 34-day MA: 301

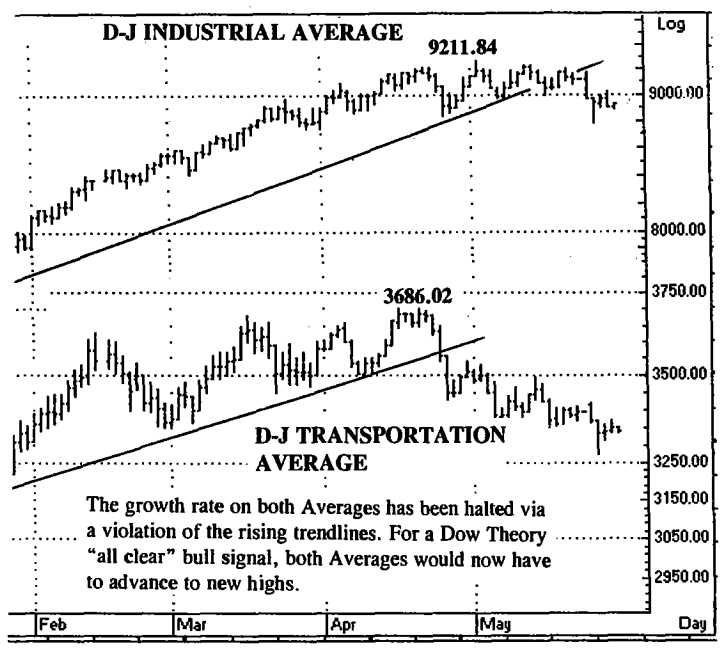
The Transport decline has had the effect of putting the brakes on the Dow's advance. But despite continuing Transport weakness, the Dow has stubbornly refused to break down below its important April 28 closing low of **8898.96** -- so it's a stand-off, with the winner yet to be declared (but keep your eye on Dow **8898.96**).

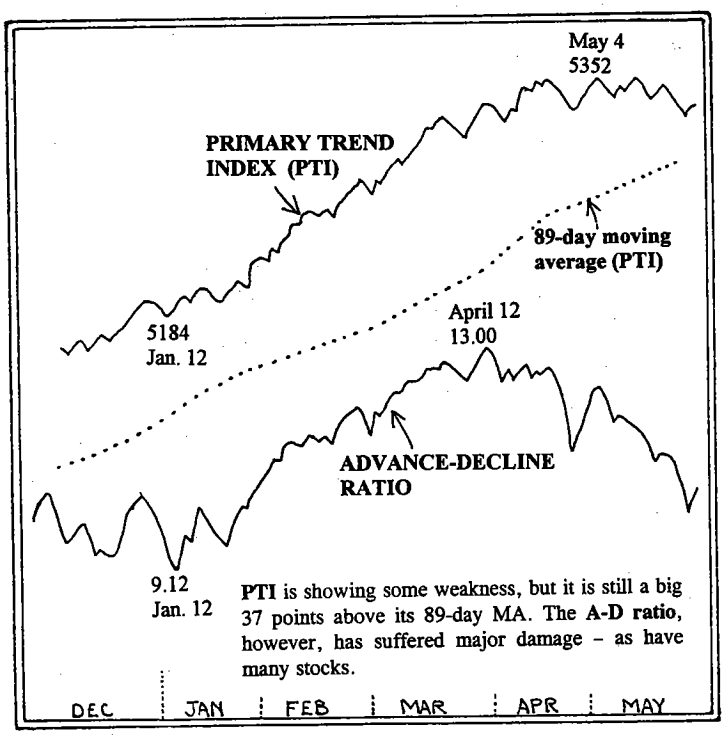
Breadth: Generals alone cannot win a war. It takes the troops following the general to win a war. By the same token, the Dow alone cannot win a war or make a bull trend. It takes the Dow accompanied by a rising trend on the part of the **majority** of stocks on the NYSE to make a bull trend.

And that was pretty much the story up to April 3. But since April 3, more stocks on the NYSE have declined than advanced. This phenomenon can be followed by tracking the advance-decline ratio. The A-D ratio (see page 2 chart) decline began on April 6 and continued to May 27. The decline in the A-D ratio, in fact, was severe with many stocks suffering damage.

The big question now is -- will Dow leadership, having resisted persistent A-D weakness, have the power to carry the rest of the market to new highs? Or has there been so much technical damage that the market balance has been irrevocably tipped to the downside? It's going to take time before we can know the answer to that critical question.

The Russell guess: **When the A-D ratio falls this far,** it's telling us that something is wrong. As I see it, even if we get a new high on the Dow, that high would simply be **another unconfirmed high,** since it doesn't appear that either the Transports or the A-D ratio are in any position to confirm.





Interesting Item: Along with the lagging breadth, the weekly list of new highs on the NYSE has been contracting. **Proof:** For the week ending April 3 there were 644 new highs on the NYSE. For the week ending April 10 there were 437 new highs. Week of April 17 -- 506 new highs. April 24 -- 415 new highs. May 1 -- 202 new highs. May 8 -- 262 new highs. May 15 -- 251 new highs. May 22 -- 178 new highs. May 29 -- 131.

DID WE SEE "URGENT SELLING?" Back in the '80s a brilliant friend of mine, James Alphier, did a vast amount of research on the identification of market tops and bottoms. One of Jim's studies (it actually appeared in the March 19, 1984 issue of *Barron's*) was entitled, "Urgent Liquidation." In that article Alphier noted that whenever a stock average declines on 12 or more out of the previous 15 days, such a persistent decline constitutes what Jim termed "urgent selling." A series of one or more strings of urgent selling generally identifies the low for a move and more often than not it identifies an important "buy spot."

All of this has to do with the action of the advance-decline ratio during the month of May. May 26 (last week) represented the 12th day of declining breadth out of the preceding 15 trading days. On May 27, breadth declined again, surpassing 12 out of 15 days, and making it an extraordinary 13 out of 16 days of declining breadth. Although breadth is not a stock average, and Alphier wrote about stock averages, I took the 13 out of 16 days of declining breadth (May 5 to May 27) to represent one of those rare periods of "urgent selling."

On top of that, the Dow and the S&P 500 on May 27 were down substantially intra-day (at one time during the day the Dow was down over 175 points), but both Averages rallied later in the day and refused to confirm on the downside. The period of urgent selling, the refusal of the "big averages" to break down, all of this suggested that the market was at least temporarily sold-out and ready to reverse to the upside.

What can we expect next? A great deal of damage has been done to both the Transports and the advance-decline ratio. I think we can expect a rally in the major averages, possibly even new highs in the Dow -- but even if that occurs, I would not expect the Transports or the A-D to confirm. Therefore, my guess is that on the big picture the market will remain locked in a broad trading range (the same trading range it has been in ever since March). The "easy money" has been made, and from here on selectivity, volatility and erratic movements will be the name of the game. Furthermore, it is very possible that a major market top is in the process of forming.

One more comment: The **bonds** have acted well, and that constitutes a plus for the stock market. Over and over again the long bond has tested the 6% yield level, and again and again that level has been rejected. The stock market likes nothing better than a firm or (better still) a rallying bond market. And that's what the market has had, at least up to now.

INVESTMENT POSITION: The bull remains in the box, but keep a close eye on the PTI. Actually, the PTI looks poorer than it has in a long time in that it has broken below a preceding low, but happily it is still about 30 points above its 89-day moving average. Keep your technical fingers crossed.

I've been getting a lot of mail regarding my stand on Treasury bonds. Subscribers ask, "Isn't it true that with Asia in trouble, many Asian individuals and banks may cash in their T-bonds to raise cash?" Answer: Maybe. But with government bonds yielding 1.2% in Japan, it's just as likely that Japanese money will be coming here looking for "our fat yields" of almost 6% on US T-bonds. On top of that the collapsing yen (against the dollar) makes holdings of US securities doubly attractive.

Nobody's been talking about this, but if the US stock market lapses into a trading range, stock-buyers will be collecting 1.5% or less in the way of dividends. What I'm saying is that with stocks providing record LOW dividends, if stocks don't go up, buyers will be sitting with literally no return. And this in the face of 5.50% returns on one-year T-bills or almost 6% on long T-bonds. Furthermore, if stocks (hey, God forbid) go down, stockholders will be losing money with almost nothing in the way of dividends to brake the decline (just imagine if stocks go down to the point where they provide a 3% yield, and a 3% yield used to be the danger level).

Conclusion: At this juncture, I prefer putting new money into government paper. Question: Why aren't stocks continuing to roar higher? Answer: I think analysts are now revising their estimates of future growth in earnings.

OLD TIMERS: Question: What's the matter with old-timers? Why are they always writing about "danger," and why are they always issuing warnings about the stock market being "overvalued"? Why can't they just relax and "get with the program," why can't they just enjoy the biggest bull run in US history?

Answer: Ah, it's a sad but fascinating story. Old-timers, market veterans, have to live with their past experiences. And past experiences have shown them that every movement in the stock market, whether minor, secondary or primary, **is ultimately corrected.** Furthermore, history has demonstrated that as a rule, the bigger the move the bigger the correction.

So hasn't this been one of the greatest advances in history? And hasn't it gone uncorrected longer than any other advance in history? And isn't it a fact that we haven't had a true bear market since 1973-74? So as this extraordinary bull market plowed higher and higher, old-timers worried and continued to worry. "The bigger the rise, the harder the fall, right? Well, isn't that right?"

You can't teach an old dog new tricks. And this market has produced a slew of new tricks. One new trick is that this market

hasn't been corrected. Another new trick is that valuations have been ignored. Still another new trick is that earnings growth has been extrapolated well into the future -- but the truth is that nobody on God's green earth really knows what earnings (or interest rates) will look like in '99, or even in late '98 for that matter. So old dogs, market veterans, they just can't get with the bullish program.

Example: In a recent issue of *Fortune,* a piece by Paul Krugman, professor of economics at MIT, is entitled, "The Ice Age Cometh." Krugman's article ends, "Okay, okay, I know that sophisticated investors are supposed to take the long view and arbitrage away the boom-bust cycles . . . The whole situation gives me the chills. It could be that I'm just a Neanderthal too thick-skulled to understand the new era. But if you ask me, there's an Ice Age just over the horizon."

Wait a second, here's a book just published, and it's entitled, "Prosperity, the Coming 20-Year Boom and What it Means to You," by Bob Davis and David Wessel. The old-timer shakes his head in disbelief, "You see," he growls, "now these young whipper-snappers are beginning to believe their own BS." I tell you, this new book scares me. Twenty years of prosperity -- the two guys who wrote this book couldn't tell us what's going to happen next week, much less what's going to happen over the next 20 years.

So that's why a lot of market veterans haven't been able to get with the bull market over the last two or three or even five years. It's one for the books, but then -- every year is one for the books in this business.

NOTES & QUOTES: The Asian situation worsens. The yen has fallen through its recent floor and now sells at 136 to the dollar, the lowest price against the dollar since 1991. The Russians ponder devaluing the ruble, and on May 18 the Russian stock market dropped a huge 12%. Meanwhile, China wrestles with massive unemployment and a sharp drop-off in their exports. The question everyone is wondering about -- will China finally devalue the yuan and will the Hong Kong dollar hold? Ed Hyman's *ISI* offers a list of problems coming out of Asia. Here it is, and it's not pretty.

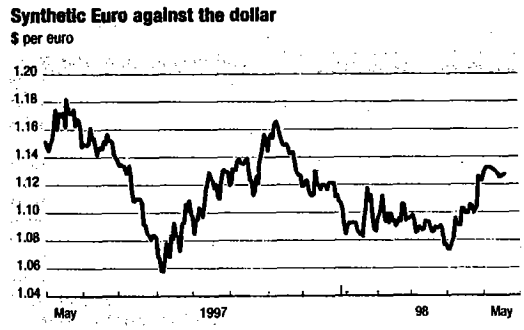
1. ***Hong Kong unemployment is increasing at its fastest pace in 20 years***
2. ***Hong Kong employment is declining at a –5% annual rate.***
3. ***Hong Kong export orders are declining at a –25% annual rate.***
4. ***Hong Kong retail sales are declining at a –40% annual rate.***
5. ***Singapore exports are declining at a –20% annual rate.***
6. ***Singapore imports are declining at a –45% annual rate.***
7. ***Singapore retail sales are declining at a –22% annual rate.***
8. ***Singapore auto sales are declining at a –26% annual rate.***
9. ***Thailand auto sales are down –69% y/y.***
10. ***Malaysia auto sales are down –74% y/y.***
11. ***Philippines imports are declining at a –18% annual rate.***
12. ***Korea real average monthly earnings are declining at a –19% annual rate.***
13. ***Taiwan industrial production is down –9% y/y.***
14. ***Taiwan export orders are declining at a –16% annual rate.***
15. ***Vietnam exports to other Pac Rim economies are down –42% y/y.***
16. ***Indonesian meat consumption is down -50%.***
17. ***Singapore's CPI is deflating at a –3% annual rate.***
18. ***Hong Kong's retail prices are deflating at a –2% annual rate.***

* *

Now, what I predicted months ago is occurring in Asia and particularly in Japan. In the face of the ever-cheaper yen, US companies are buying up Japan, often at prices 90% below the peak prices of a few years ago. And, of course, there's the expected screaming by the Japanese, who are claiming that the US is taking advantage, that the US is a raptor, that the US must be stopped. Of course, a few years ago when the yen was powerful, and it was widely claimed that Japan's way was the way of the future, the situation was reversed. Remember when the Japanese were buying everything in sight here in the US. The worm has turned, and the Japanese hate it. Meanwhile, US brokerage firms are rushing into Japan, intent on capturing a portion of the massive $9.3 trillion in Japanese savings. Japan offers savers a pathetic 1.2% on their bonds and postal savings. This means that US brokers are in there ready to "rock and roll." The outflow of money from Japan and Asia could be huge.

* *

What's an euro worth? Euro contracts are trading now, and according to the charts the euro is worth around $1.12. And I have to wonder, is it just a coincidence that the euro is worth about 12% more than a dollar? Wouldn't Europeans feel rather proud if the euro continues to be worth more than the Yankee dollar? I think they would.



* *

Are there really such phenomena as coincidences? Check this out. Only 13 perfect baseball games have been pitched in the last 100 years, two of them from a Yankee. There are thousands of high schools in the nation. The first Yankee perfect game was pitched by Don Larsen in '56. The second was pitched by David Wells on May 17. What are the odds that both of these amazing pitchers came from the same high school 3000 miles from New York? The odds must be one in eight billion. Yet both of these Yankee pitchers came out of Point Loma High School here in San Diego. Incredible.

* *

I have my Internet coming through via the cable (it's called "Road Runner," a division of Time Warner), and with the cable the action is **fast** -- without cable the Internet was so slow I almost never used it. So I've been spending a good portion of my recent weekends glued to the Net using Internet Explorer. And if you haven't spent time on the Net I can tell you that it's amazing. I looked up everything from Cacti and poodles and mites to foreign markets, Bloomberg, Decision Point, Drudge, Salon, you name it, the information is absolutely endless. You can even get the foreign newspapers, London, Amsterdam, South Africa. The trick, I think, with the Internet is to locate useful sites. There is just so much on the Net that you can spend days searching for the sites you want. Once you find them you can lock them in under "favorites," and then check them out at will. Trouble is that I now have too many favorite sites. If you don't believe we're living in different times, get on the Net. We're really living in one world now, and it's all yours, once you get on the Net via cable.

* *

Vincton Cerf is often called "the father of the Internet." He's co-designer of TCP/IUP protocol, which is the set of rules that allows computers to share information on the Net. Cerf has watched the Net move far beyond its original intention as a source of scientific and military information. Asked about projected growth, Cerf said, "Our current estimates are that in January of '98 there were 30 million computers on the Net and about 70 million users. I'm projecting somewhere between 100 million and 200 million computers by the end of December 2000

and about 300 million users by that same time." Asked whether he was surprised at the Net's development, Cerf answered, "I don't think I had quite anticipated the side effect of putting it in the hands of the public. What has happened is an absolute explosion of creativity and entrepreneurial ideas. People come up with really astonishing ways of using the Net, and I find that to be both surprising and exhilarating, because it's like watching a thousand or a million geniuses -- well actually it's more like there are a million people out doing things, and there are a few geniuses that pop out."

* *

With over 40% of US families now owning some kind of mutual fund, the feeling among Americans is that these funds are in wise hands and that they constitute some kind of "savings." Let me put it this way -- mutual funds are only savings during a bull market. My old friend, Charles Allman (PO Box 15381, Chevy Chase, MD 20825), keeps all kinds of records, and he recently published the records of a number of leading mutual funds during the period of 1970-74. Here are the results and they are worth studying. My belief is that when the next primary bear market hits, the public will tend to sit and sit, then slowly bail out of their funds as the losses build up. But the bear market will be extended both in duration and severity because the public will only slowly move to cut their losses. Just as massive public participation extended the bull market on the upside, taking it to amazing heights, so the public will extend the next bear market, taking it to surprising lows over a surprisingly long period of time.

	Change 1972	% Change 1973	% Change 1974	Value of $10,000	% Change 1970-1974
Eaton & Howard Growth	23.2	−32.7	−44.8	4,949	−50.5
Enterprise	3.9	−21.5	−32.6	4,714	−52.9
Fidelity Trend	13.0	−24.9	−33.1	5,887	−41.1
Growth Fund of America	−21.4	−27.9	−25.7	4,990	−50.1
Hartwell Growth	−9.5	−34.7	−24.7	4,694	−53.1
Manhattan	−4.0	−30.8	−36.5	2,888	−71.1
Mates Investment	−.6	−54.5	−30.4	1,961	−80.4
Midamerica Mutual	14.2	−30.2	−29.2	5,063	−49.4
Nicholas Fund	28.1	−52.7	−33.7	5,634	−43.7
Pennsylvania Mutual	−2.0	−48.5	−46.0	1,312	−86.9
Pilgrim Fund	9.9	−40.0	−32.0	5,299	−47.0
Price New Horizons	21.1	−40.3	−39.0	5,890	−41.1
State Farm Growth	11.7	−14.1	−28.3	5,899	−41.0
Value Line Fund	9.6	−30.9	−24.0	4,930	−50.7
Vanguard	−22.9	−67.4	−10.3	2,224	−77.8
Windsor	6.3	−27.8	−20.9	6,516	−34.8

* *

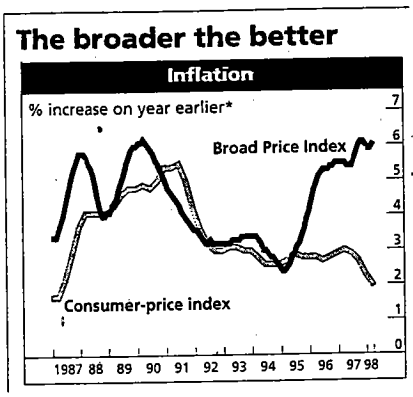
How long will it be before more and more people will be corresponding via E-mail and actually talking to each other via the cable? I can't think it will be too long. As Rich Karlgaard of *Forbes* put it, "The only hope for America's aging circuit-switched, copper-based telephone companies is to raise enough capital through mergers to fund a massive overhaul into high-capacity lines and Internet protocol switches." So I have to wonder, how can the telephone companies survive? And how will the post office survive (particularly when those idiots at the PO keep raising the price of "snail mail")? Only a government outfit would raise prices in the face of continuing vicious competition. There's a new world a'comin' -- wait, I think it's here.

* *

Speaking of new worlds, Stanford University researchers are developing a revolutionary new technology that could lead to digital cameras so small and so efficient that they could fit on a watch band. In fact, five major companies (Canon, Kodak, Hewlett-Packard, Intel and Interval Researched) have put up $4 million for a four-year research project. At the heart of the project is a radical approach to digital imaging that many thought would be impossible. Said Ed Gamel, one of the researchers, "Digital cameras are going to enormous markets." He sees them eventually taking the place of film in most cases. In time he believes every vehicle will be equipped with seven or eight digital cameras which will monitor everything from road conditions to nearby traffic.

* *

The London *Economist* has been warning that the Fed is lagging badly in the inflation fight. Raise rates before it's too late, cries the *Economist*. In the May 9 issue, the widely-read magazine includes two charts (below), one showing the "real" inflation rate. The real rate, they state, includes the inflation of financial assets (houses, stocks, bonds, etc.), assets which the government ignores in its inflation statistics. This is the Deutsche Morgan Grenfell index, which includes changes in consumer and producer prices (80%), property (15%) and share prices (5%). The chart shows inflation rising at a 6% rate. The rise in the broad money supply (M-3) fits closely with the Deutsche Index. **Russell Comment:** I've been saying all along that the government's inflation indices are a joke. I'd say that the Deutsche index is about right, that is, inflation is rising at about a 6% rate at present.



Home Values Surged 9.1% During the First Quarter

By a WALL STREET JOURNAL *Staff Reporter*

A healthy residential housing market strengthened even more during the first quarter, reaching the highest rate of home appreciation this decade and raising questions about whether parts of California's housing market are heating up too fast.

Experian Real Estate Solutions, a real-estate information concern, said first-quarter home values rose 9.1% compared with the year-ago period. That is well above the 2.5% average annual rate homeowners have seen during the 1990s. The increase was fueled largely by double-digit increases in California, leading to fears that the real-estate market in

* *

Omens: Because nobody knows where the market is heading tomorrow or next week or next month, everyone on Wall Street looks for omens. Here are two: It is said that stocks go the way of women's hemlines. Why? Well, when women feel good, as they have in recent years, they show a lot of leg and hemlines go high, higher, highest. When women begin to feel anxious or gloomy, hemlines head south. This clip is from the May 3 *NY Times*. Another omen: Stocks go with the price of a seat on the NYSE. Last week for the third time, the price of a NYSE seat dropped. On March 9 a buyer paid a record $2 million for a seat. The next sale went for $1.4 million. Then last week a seat sold for $1.35 million. This is the first time in eight years that seat prices fell in a three-set series. In 1990 when 28 seats were sold, the price fell eight times in succession.

THE NEW YORK TIMES **FASHION** TUESDAY, MAY 5, 1998

Sign of Autumn: 'Watch for Falling Hemlines'

By ANNE-MARIE SCHIRO

Last fall, designers were fixated on tough chic, as epitomized by the power suit with its square shoulders and sheer skinny skirt. The styles were barely in stores before designers switched their focus to soft romantic clothes for spring. Out of those came the emphasis on long skirts in the recent fall shows in Europe and New York.

That's quite a turnaround in a year.

But it's one that doesn't surprise fashion professionals.

"There's something in the air that people don't understand," said Kal Rutenstein, senior vice president for fashion direction at Bloomingdale's. "It's a feeling. We all have a feeling for something. This fall, it's long skirts."

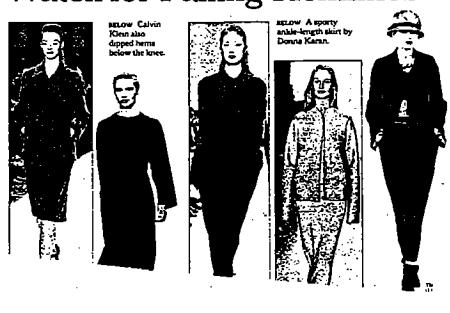
Yoshiki, for one, started designing long skirts for her current spring collection, now in stores. "It was without premeditation," she said. leads me to want something softer, prettier, easier, more romantic. Fashion is supposed to keep moving, to keep changing. That's what we do."

Mr. Klein experimented with long loose dresses in his resort collection last year and carried the idea into spring.

This fall he found himself in the company of designers as varied as Marc Jacobs, Michael Kors, Yeohlee, Narciso Rodriguez, Oscar de la Renta and Karl Lagerfeld, all of whom stressed long skirts.

Donna Karan, who has always shown long skirts in her lower-priced DKNY collection, came out strongly for longer lengths in her fall signature line, as well. She has been wearing long lengths herself for several years. So have many young women who found the skirts in trendy boutiques stocked with avant-garde clothes.

Trends don't come from just one place but depend on a combination of



BELOW Calvin Klein also dipped hems below the knee.

BELOW A sporty ankle-length skirt by Donna Karan.

* *

Frank Sinatra is gone. I first saw Sinatra at the old Paramount Theater in NYC; it was around 1941. His manager had hired a dozen teenagers to shout and scream, but both Frank and his manager were amazed when hundreds, later thousands, of "bobby-soxers" joined the "insiders," and hysterical bobby-soxers became a national phenomenon (to be followed later by screams for Elvis and then the Beatles). The guys I hung out with were all died-in-the-wool jazz fans, but Sinatra was very hip; he sang with both Goodman and Dorsey, and he was heavily influenced by Billy Holiday, so we reluctantly accepted him. Sinatra (along with Tony Bennett) successfully survived rock and roll, and "Frankie" made a fortune "his way." To his great credit, Sinatra almost single-handedly kept the great songs of the '30s, '40s and '50s alive -- and I thank him for that. **Russell Opinion**: The great pop ballads will live forever, but

95% of the thousands of rock and roll recordings will die out within a few years.

* *

Most of Silicon Valley hates **Microsoft.** Says Larry Ellison, CEO of Oracle Corp., "Bill's call for an opportunity to innovate is the big lie theory. His idea of innovation is to take other people's technology, copy it, put it into the operating system, and then raise the price of the operating system. Who's kidding who?" At any rate, on May 18 the Justice Dept. decided to sue MSFT, attempting to force it to change the way it does business. The *WSJ* wasn't impressed. They called it "Microslop." The *Journal* believes that by the time this suit is concluded, the whole situation will be so different, so advanced, that "before this ball comes down, the stands will be empty and the fans will have gone home." The *NY Times* differs. Says the *Times* (May 19): "In their sweeping antitrust suit against Microsoft, the Justice Dept. and 20 state attorneys generals have made reasonable demands to preserve competition in the world of computers. Bill Gates needs to respond with something better than disingenuous countercharges that his company is being punished for its success." **Russell Comment:** Microsoft has a monopoly in that 90% of all computers run on its system. It's a monopoly that was made possible due to Apple's stupidity. What is MSFT really afraid of? It's that another browser (Netscape) will capture a large percentage of Net users and then some outfit will come along and provide a substitute for Windows (MSFT's basic product is Windows). Also, it's possible, even probable, that ultimately the Net itself will replace much of what is useful on Windows. At one point MSFT offered to divide the market with Netscape. Netscape refused. Now the Justice Dept. wants to force MSFT to desist from "anti-competitive and exclusionary" practices which force computer makers to rely solely on its Windows products. That's going to be tough and it's going to take, maybe, years. And that's probably what MSFT is counting on. Won't the case cost MSFT a fortune? What does MSFT care, they have a kitty of $12.3 billion in cash. MSFT is stupid to fight the government. They should have settled. This case will be continuing BAD public relations for Gates and will conceivably drag on forever. Critics say that Gates' past successes give him a false confidence to challenge the government as if the government was just another competitor. Says Jesse Berst, editorial director of Anchor-Desk, "He's clawed his way to the top, and then he kept on clawing. That's not the right way to win against the government. It's like a hockey player who body slams an opponent and gets the whistle, so he slams the referee. It may take 10 years, but I think this is a watershed, and a Waterloo for Microsoft."

* *

My sister-in-law and her family live in Woodside, in the heart of **Silicon Valley** (she and her husband both used to work at Apple). Faye and I stayed with them a few weekends ago, and on Sunday I woke up and immediately started looking for a *New York Times*. They didn't subscribe, so I told Faye, "Look, I've got to have a *Times*. Without the *Times* I don't know what is going on in the world. A *Times,* my kingdom for a *Times."* (Note: Ex-New Yorkers can't survive without the Sunday *Times*; many, including me, can't survive without the daily *Times*.) So Faye and I went out looking for a *Times*. There were none. In all of Silicon Valley we couldn't find a single *Times*. That told me a lot about Silicon Valley and the computer nerds. These people are in their own world of computers and bandwidths and discs. They don't know there's an outside world, and I'm not sure they care. They still think John Kennedy is President. I couldn't believe it. Finally, Faye said, "Hey, there's a hotel where some of the people from my law firm stay when they're dealing with these people. I'll bet they have a *Times* there." We raced to the hotel, and voila, Faye was right, they had two Sunday *Times* in the lobby store. When we got back to my sister-in-law's, we told them that we were buying them a subscription to the *Times*. "You'll love it," I said, "Keep reading it, and before you know it you'll feel like you're in the real world." Note: Here in La Jolla civilization reigns. They sell the *Times* on every other block, along with *Barron's*, the London *Financial Times* and *Investor's Business Daily*.

* *

The Balanced Budget Lie: Both political parties have given up on balancing the federal budget without stealing money from the Social Security system. The so-called surplus of today has been brought on by taking money from SS, by a huge tax take from booming business and even bigger booming stock market profits (more taxes), and from a huge take from individual taxes. The continuing "surplus" that the government is promising is based on a future of continuing booms, no recessions and no war. Don't count on it. Actually, if the budget was balanced there would be no increase in the national debt. It hasn't happened. The latest figures show that over the last 12 months a total of $152 billion has been added to the national debt. That's more than 12 billion bucks a month -- I'd call that real money. A newsletter from T. Rowe Price says: "In the bizarre accounting used by the federal government, one part of the government -- the US Treasury -- is selling bonds to another part of the same government -- the Social Security Administration. This is identical to funding your own retirement with IOUs written to yourself during your working years."

* *

The **Federal Reserve** was formed in 1913, and ostensibly its purpose was to provide the nation with the right amount of money for its needs and also to protect the value of the dollar. The statistics are interesting. *The American Institute for Economic Research* (Great Barrington, MA) provided these figures for the relative Purchasing Power of the Dollar. **Starting with 100 dollars in 1945,** that same $100 purchased $72.80 worth of goods in 1950; it bought $61.10 of goods in 1960; in 1970 it bought $45.70; in 1980 it bought $21.10; in 1990 it bought $13.60. Finally, by 1996 that old 1945 hundred dollars bought $11.50 worth of goods. So since 1945 the dollar has lost roughly 88% of its value. Was the Federal Reserve protecting the value of the dollar over the years? Hardly. This is why many conservatives call the Fed "an engine of inflation."

* *

The fact that during the election campaign the **Democratic Party** accepted money from the "Chinese People's Liberation Army" is beyond belief. Clinton claims that he "had no knowledge" of where the money came from. Did you ever hear of a politician not knowing who was giving him money! But all remains quiet. The American public, up to now, has been disinterested or maybe mildly amused by Clinton's adulterous adventures. But this latest scandal, having to do with possible national security, may be the straw that broke the public's collective back. News tends to go with the trend. Thus, Clinton better hope that the trend of the market remains bullish. Writes Walter Shapiro in *USA Today* (May 20), "Clinton defenders have grown adept at ridiculing all charges against the president as either rooted in tabloid titillation, Kenneth Starr's vendetta, long-ago events in Arkansas or a right-wing conspiracy. But this campaign scandal involves none of these convenient villains. It all harks back to a president and a White House run re-election campaign that would do anything for a buck, perhaps, in the worst case, even jeopardizing national security." **Russell Comment:** The list of Clinton's transgressions and lawlessness has become so extended and so flagrant that I detect the American public finally beginning to turn less "forgiving" of the president. If the stock market turns down, Clinton could be halfway out the door.

* *

You don't know gambling (er, speculating) until you've seen the World Championship of Poker at Binion's Horseshoe in Las Vegas. My son-in-law, Vince Van Patten, hosted the affair via the ESPN broadcast. On the third day of the great contest, after 30 straight hours of play, the game was down to three players, T. J. Clouter, a 6'4" former pro football player, Thuan "Scottie" Nguyen, a former poker dealer from Vietnam, and Kevin McBride, a businessman out of Boca Raton. Between the three they were in control of $3.5 million in cash. Clouter had $700,000, Nguyen had $1.2 million and McBride had $1.6 million. Clouter goes out first. Nguyen and McBride fight it out. After losing a few big pots to Nguyen, McBride goes to the

bathroom. Nguyen is annoyed, "Where did he go? Can he do that?" When McBride returns, Nguyen goes for the big one. He makes an enormous raise against McBride. "Call me and it's all over," says Nguyen, staring straight into McBride's eyes. McBride mulls it over and pushes his last chips onto the table Nguyen has the cards, 9s over 8s. "He trapped me, I didn't believe him" groans McBride. He nevertheless leaves with $687,000. Nguyen tosses his winnings into a cardboard box, raises his arm in victory, and walks out a millionaire. Only in America.

* *

Speaking of Las Vegas, the city now has more hotel rooms, 106,100, than any city in the nation. NYC is second with 66,600 rooms. But Vegas' rooms have the nation's highest occupancy rate, 84.6% vs. NYC's 64.5%. **Russell Comment:** Both cities will take your money in a heartbeat, but the food is a lot cheaper in Las Vegas.

* *

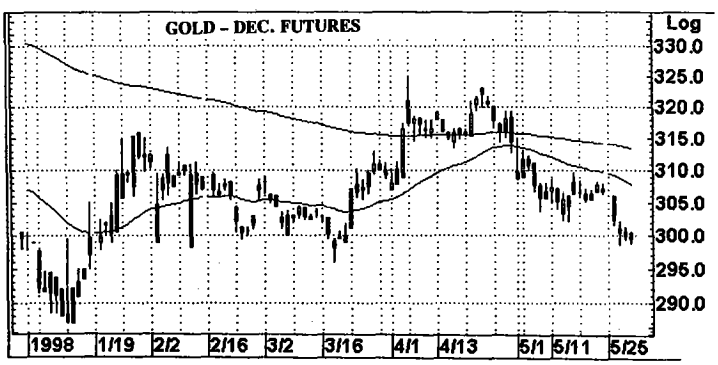
Will Wall Street get a bad name? A coming film, "American Psycho," is about a Wall Street banker who turns serial killer. The lead will be played by none other than heart throb Leonardo DiCaprio. Leo's reported take for the movie, a staggering $21 million. Only in America.

* *

Warren Buffett must be turning cautious. In the first quarter of '98 Berkshire reported gross capital gains of $700 million. Buffett told *Forbes* that he expects "gross capital gains of close to $2 billion in '98." That could amount to sales of $4 to $5 billion in stocks and bonds, which would amount to about 10% of Berkshire's entire portfolio. Berkshire pays taxes of 35% on capital gains, and for a guy who likes to hold forever, this means that Buffett is lightening up.

PRECIOUS METALS: The news here just isn't encouraging. Maybe it can all be summed up in this chart of XAU, the widely-followed Phila. Gold/Silver Average. What we see is a "head-and-shoulders" top pattern with a weak, extended right shoulder and then the sharp break which occurred on May 26.

Technically, aside from the H & S breakdown, two other items appear on this chart. The first is that last week the 34-day moving average of XAU broke below the longer-term or 144-day MA. That's always bad news. The other item is that on May 26 XAU broke below the long rising trendline that extends up from the mid-January low.



Gold itself doesn't look any better. On May 1 the December gold futures broke below their 34-day MA with the 34-day MA bearishly holding below its 144-day MA. This constituted a "sell signal" on the Russell method of reading the moving averages. Hopefully, gold will hold close to the critical 300 level. But with all of Asia's currencies (including the ruble) on the rocks, it's not bullish that gold has acted so poorly. Still, some fools like the writer continue to hold gold coins. Why? They're beautiful (so what, you idiot), and, moreover, I feel comfortable owning them in this world of paper.

LATE NOTES: There are a number of things about this market that I don't like. **(1)** After a two-month decline in the A-D ratio, the A-D appeared "over-sold," and on Thursday and Friday of last week the A-D finally rallied. But Friday's rally was pathetic with the Dow sinking 70 points even though the A-D rose. Monday opened with the A-D lower. **(2)** I keep an A-D line of just the 30 Dow Industrial issues, and that index just broke to its lowest level since mid-March, at which time the Dow was in the low 8700s. The Dow often **follows** its own A-D both up and down. **(3)** The important April 28 low closing for the Dow was **8898.96** as discussed on page 1 of this Letter. The Dow closed Friday (May 29) at 8899.95, just a point above its 8898.96 level. A Dow close below that April 29 low would be bearish. **(4)** The week ending May 29 produced only 131 new NYSE highs, the lowest total in many months. **(5)** Up until recently, the stock market **was** extraordinarily sensitive to the bonds. Six months ago if the bonds had ticked up just a few 32nds, the market would have rallied. Note this -- the bonds since April 11 have rallied strongly, but the market since late-April has been sloppy to weak. The parting of the ways between stocks and bonds is **not** a good sign. It suggests that large investors are willing to forego any capital gains from stocks while moving into the safer and much higher yield area of bonds. Rising bond prices and declining stock prices are an indication of **deflation.**

Speaking of deflation, it's now apparent that Russia and most of Asia are deflating, with many Asian nations on the verge of recession or worse -- depression. And what's worrying the US stock market is that Asia is beginning to export its deflation here. The only areas holding up so far (non-deflating) are the US stock market and US real estate. If those two go, the US could be in recession by the end of this year.

The bond market senses deflation, and investors are rushing to lock in income, meaning yields of 5-6% via the bond market. The following is from the "Current Yield" column in the June 1 *Barron's*: *"It's good to be the only game in town. It's even better to be the only game on the globe. The US bond market is on the verge of this enviable position as the spreading Asian financial crisis and a wobbly stock market steer capital towards dollar-denominated debt securities."*

The June bond contract is where investors' eyes should be glued. On February 17 the June contract peaked at 122 8/32nds. From there there was a big decline and then a rally. On April 3 the June contract peaked at 122 14/32nds. Another decline and another rally. As this is written, the June bonds are at 122. The BIG question -- will the bonds rally to 123 or better or will they top out again? Above 123 would represent an important breakout for the bonds.

Along these same lines, the D-J Utility Average is now within a few points of its April 2 record high close of 291.18. A rising trend in BOTH bonds and utilities has almost always been bullish for the stock market. In my opinion, the single most bullish factor in the market now is the trend of bonds and utilities. **The current reality** -- the highest quality stocks are holding and anything less than quality is trending down.

NEXT MAILING: June 17, 1998